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In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 368

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

MARGARET BATTS TOBIN

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

EDGAR G. TOBIN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgments of the United States Court of Appeals for the Fifth Circuit, entered in the above-entitled cases.[1]

[1] By order of the court below, the two cases, involving identical issues, were consolidated for record, briefing, hearing and opinion in that court.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 77-123) are reported at 11 T.C. 928. The opinion of the court below (R. 435-8) is reported at 183 F. 2d 919.

JURISDICTION

The judgment of the Court of Appeals was entered on July 19, 1950. (R. 438.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTIONS PRESENTED

The taxpayers, husband and wife, on two occasions simultaneously created virtually identical irrevocable trusts out of community property, naming the other spouse as income beneficiary. The income of each trust was to be distributed by a corporate trustee at the direction of an "advisory" committee consisting of the respective beneficiaries, close relatives and employees of the husband. The Tax Court found that the trusts were reciprocal and the income therefore taxable to the respective beneficiaries under Section 167(a)(2) of the Internal Revenue Code. The questions presented are:

1. Whether, in circumstances giving use to a legitimate inference that trusts are reciprocal, the Tax Court may require that the beneficiary of each such reciprocal trust be treated as grantor for federal tax purposes.

2. If so, whether each spouse is taxable on the

income of the trusts as community income because the income could have been distributed to each as grantor, in the discretion of persons not having a substantial adverse interest in the disposition of the income within the meaning of Section 167(a)(2) of the Internal Revenue Code.[2]

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from * * * any source whatever. * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 167. INCOME FOR BENEFIT OF GRANTOR.

(a) Where any part of the income of a trust—

* * * * *

(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or

(3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such

[2] In the event that the petition is granted, the further questions of whether, irrespective of the doctrine of reciprocal trusts, any part, or all, of the income in question was taxable to the respective spouses as community income either under Section 22(a) or Section 167(a)(2) (and the rule of *Helvering* v. *Clifford*, 309 U.S. 331) are reserved.

part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in section 23(o), relating to the so-called "charitable contribution" deduction): then such part of the income of the trust shall be included in computing the net income of the grantor.

(b) As used in this section the term "in the discretion of the grantor" means "in the discretion of the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of the part of the income in question."

(26 U. S. C. 1946 ed., Sec. 167.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:[3]

Sec. 19.167-1. *Trusts in the income of which the grantor retains an interest.*—(a) *Scope.*—Section 167 prescribes that the income, or any part of the income, of certain trusts shall be taxed to the grantor, not because the grantor has retained a certain interest in the *corpus* of the trust (as in section 166), but because of his

[3] Treasury Regulations 103 are applicable to the years 1940 and 1941. Treasury Regulations 111, also promulgated under the Internal Revenue Code, are applicable to the later years. The corresponding provisions of Treasury Regulations 111 do not differ in any material respect from the provisions of Treasury Regulations 103 as set out above.

retention of a certain interest in the *income* of the trust. This section deals with the taxation of such income. The term "income," as used in this section, means any part or the whole of the income of the trust.

(b) *Test of taxability to the grantor.*—The test prescribed by the Internal Revenue Code as to the sufficiency of the grantor's retained interest in the trust income, resulting in the taxation of such income to the grantor, is whether he has failed to divest himself, permanently and definitively, of every right which might, by any possibility, enable him to have such income, at some time, distributed to him, either actually or constructively. Such a distribution to the grantor occurs within the meaning of section 167 if the income is paid to him or to another in obedience to his direction or if the income is applied in payment of premiums upon policies of insurance on the grantor's life.

For the purposes of this section, the sufficiency of the grantor's retained interest in the income is not affected by the fact that the grantor has provided that the right so to effect or direct the distribution of income is, or may at some future time be, vested in any person (either alone or in conjunction with the grantor) not having a substantial interest in the income adverse to the grantor. A bare legal interest, such as that of a trustee, is never substantial and never adverse.

If the grantor has retained any such interest in the income, such income is taxable to the grantor regardless of—

(1) whether it may be distributed currently or accumulated for future distribution;

(2) whether such distribution, either current or subject to accumulation, is fixed by the trust instrument or is dependent on an exercise of discretion;

(3) whether, if such distribution is in any way effected by or dependent on an exercise of discretion, the person exercising the discretion is the grantor or a person not having a substantial interest in the income adverse to the grantor, or both;

(4) the time or times of such distribution, whether within or without the taxable period, whether conditioned on the precedent giving of notice, or on the elapsing of an interval of time, or on the happening of a specified event, or otherwise;

(5) when the trust was created.

Thus, the inclusion of any trust within the scope of section 167 is based on the fact that the grantor has retained an interest in the income therefrom by which he is, or may be enabled at some time, to receive its benefits. But the provisions of section 167 are not to be regarded as excluding from taxation to the grantor the income of other trusts, not specified therein, in

which the grantor is, for the purposes of the Internal Revenue Code, similarly regarded as remaining in substance the owner of the trust income * * *.

* * * * *

STATEMENT

No primary facts are in dispute. As found by the Tax Court (R. 82-103) those relevant here may be summarized as follows:

These cases involve individual income taxes for the taxable years 1940, 1941 and 1943. (R. 79.) The taxpayers are husband and wife and are domiciled in the State of Texas. They filed separate returns for the tax years on the community property basis. (R. 82.)

Tobin's parents had been people of small financial means. His wife was the daughter of Judge Robert L. Batts of the United States Court of Appeals for the Fifth Circuit who resigned in 1919 and thereafter represented oil companies. Although he became a man of financial means, he lost his fortune during the depression which began in 1929 and was left with heavy debts. In 1935, Tobin and his wife, having in mind his former poverty and her family's financial reverses, decided each to try to protect, as far as they were able to do so, persons who were dear to them against future financial want. Accordingly, they created eight trusts from community property. Five were created by Tobin out of his one-half of the community estate and

three by his wife out of her one-half of the estate. Sawnie R. Aldredge, a lawyer and brother-in-law of the wife, did most of the work in the preparation of the trusts. He submitted rough drafts to Judge Batts who also assisted in the preparation. (R. 83-84.)

Of the eight trusts thus created, only four are in controversy here. Although the Commissioner assessed deficiencies to these taxpayers stemming from each of the eight trusts, the Tax Court decided that they were not taxable on the income from four of the trusts and the Commissioner did not take an appeal. Of the four trusts here involved, two were executed on June 14, 1935, with substantially identical terms and corpora. On that date, the wife executed as trustor the trust referred to in the record as the Edgar Tobin Trust. She was joined in the execution of the trust by Tobin, *pro forma*. On that date Tobin also executed as trustor a trust known as the Margaret Batts Tobin Trust. (R. 88-89). Each trust created a corporate trustee and advisory committee of three individuals. (R. 84.) Income of the trust created by the wife is distributable to Tobin or for his benefit, as the majority of the advisory committee may direct, supplemented in case of emergency and necessity by payment from corpus upon the unanimous direction of the advisory commitee. Similarly, income of the trust created by Tobin is distributable to his wife under identical provisions. Under both trusts, undis-

tributed income is to be reinvested and become a part of the corpus. Upon the death of the respective beneficiaries, the corpus of each trust is to become part of the beneficiary's estate, distributable in accordance with his will, or if he dies intestate, under the Texas law of descent and distribution. (R. 89.)

On November 14 of the same year, each of the taxpayers became the trustor of an additional trust, also with substantially identical provisions and corpora. The trust of which Tobin is named the trustor is known as the Ethel Murphy Tobin Trust (after Tobin's mother). It provides that the income is to be paid to his wife or for her benefit during her life as the advisory committee may direct. Undistributed income is to be added to corpus. If Tobin's mother should survive his wife, then the trust is to continue for ten years during which time his mother is to receive all of the income and ten percent of the corpus. (R. 89-90.) Similarly, the wife was named as trustor, joined by Tobin, as trustor *pro forma,* of a trust referred to in the record as the Harriet Fiquet Batts Trust (after Mrs. Tobin's mother). The net income of the trust, under provisions parallel to that of the Ethel Murphy Tobin Trust, is distributable to Tobin during his life or for his benefit as the advisory committee may direct, and upon the death of Tobin, if the wife's mother was living, the trust is also to continue for ten years, during which time

the mother is to receive the income and ten percent of the corpus. Both trusts contained remainders over in the event that the first remainderman did not survive the life beneficiary. (R. 89-91.)

None of the four trusts contains any provision for distribution to the respective trustors. (R. 89, 90, 91.) Each trust was declared to be irrevocable; each named a corporate trustee; each created an advisory committee with power to authorize income payments to the beneficiary by the majority vote and payments out of corpus by unanimous vote. (R. 89-91.) There were detailed provisions concerning the rights and duties of the trustee and of the advisory committees. (R. 91-95.) Among the provisions was that a majority of the advisory committee could remove a trustee without cause and name a successor. (R. 95.) On refusal or inability of any of the advisory committee to act, the remaining members were given the power to appoint a successor or successors. (R. 94.)

The original advisory committee of the husband's trust (the Edgar Tobin Trust) was the husband's mother, his brother-in-law and an employee of the husband for about twenty years. The husband's mother and brother-in-law resigned in 1936 and were succeeded by the husband and another employee who, in 1942, was succeeded by still another of Tobin's employees. (R. 96-97.)

The original committee of the wife's trust (the Margaret Batts Tobin Trust) was the same as that

for the husband's trust. In December, 1936, the husband's mother and his employee resigned and were succeeded by the wife and her sister. In 1940, the wife's sister and her husband, Sawnie R. Aldredge, resigned and were succeeded by Georgia C. McNemer and J. H. Frost, the president of a bank. (R. 97.)

The original committee of the Ethel Murphy Tobin Trust, of which the wife was the life beneficiary, was the wife's brother-in-law and two employees of the husband. In 1940, the brother-in-law resigned and was succeeded by Tobin and, in 1942, one of the employees resigned and was succeeded by another of the husband's employees. (R. 97.)

The original advisory committee of the Harriet Fiquet Batts Trust, of which the husband was the beneficiary, was the same as the Ethel Murphy Tobin Trust, i.e., his brother-in-law and two of his employees. The changes were the same as in the case of the Ethel Murphy Tobin Trust. (R. 97.)

During each of the taxable years, the net income of all of the four trusts here involved was accumulated and added to corpus. (R. 103.)

The Commissioner determined that the net income of each of the trusts was taxable to taxpayers as community income. (R. 14-15; 49-50.)

A unanimous Tax Court sustained the Commissioner's determination as to the four trusts here involved, and held that the net income from each is

taxable to the taxpayers as community income on the ground that the husband was in substance the grantor of the trusts of which he was the beneficiary, and the wife the grantor of the trusts of which she was the beneficiary, and that the income of each of the trusts could have been distributed to the respective actual grantors in the manner specified in Section 167(a)(2) of the Internal Revenue Code. (R. 110-114.)

The Court of Appeals for the Fifth Circuit, Judge Russell dissenting, reversed. (R. 435-8.)

REASONS FOR GRANTING THE WRIT

In refusing to allow the Tax Court to apply the settled doctrine of "reciprocal trusts" to this case, the Court of Appeals for the Fifth Circuit has created a conflict in principle with several other circuits and has erroneously decided an important question of the law relating to federal taxation. It has also seriously misconstrued Section 167 of the Internal Revenue Code—a provision designed to ensure the taxation of trust income to a grantor who earns and has power to enjoy it—in opposition to the views of other courts of appeals.

1. In order to neutralize one transparent device for the avoidance of taxes, the Tax Court and several courts of appeals have developed and followed the so-called doctrine of "reciprocal trusts", which holds that, for federal tax purposes, where two individuals create trusts for each other, and each

trust is in consideration of the other, each person will be treated, because the substance of the transaction so requires, as the grantor of the trust of which he is the beneficiary. *Lehman* v. *Commissioner*, 109 F. 2d 99 (C.A. 2), certiorari denied, 310 U. S. 637; *Orvis* v. *Higgins*, 180 F. 2d 537 (C.A. 2), certiorari denied, October 9, 1950; *Hanauer's Estate* v. *Commissioner*, 149 F. 2d 857 (C.A. 2), certiorari denied, 326 U. S. 770; *Estate of Newberry* v. *Commissioner*, 172 F. 2d 220 (C.A. 3); *Cole's Estate* v. *Commissioner*, 140 F. 2d 636 (C.A. 8); *Commissioner* v. *Warner*, 127 F. 2d 913 (C.A. 9). This salutary result is based, according to the root case of *Lehman* v. *Commissioner, supra*, p. 100, not alone on an interpretation of the revenue laws, but also on nontax trust cases and on the principle that (p. 100), "The law searches out the reality and is not concerned with the form." The doctrine has wide-spread applicability to many portions of the income tax laws clearly designed to tax trust income to those who earn it,[4] as well as to the cognate provisions of the estate tax law.[5] Cf. *Lucas* v. *Earl*, 281 U. S. 111; *Corliss* v. *Bowers*, 281 U. S. 376; *Helvering* v. *Clifford*, 309 U. S. 331; *Harrison* v. *Schaffner*, 312 U. S. 579.

In this case, the full Tax Court properly applied this doctrine in combination with Section 167(a)

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[4] See, *e.g.*, Internal Revenue Code, Section 166 (26 U.S.C., Sec. 166), and Section 167, *supra*, pp. 3-4.

[5] See *e.g.*, Internal Revenue Code, Section 811 (26 U.S.C. Sec. 811).

(2) of the Code (*supra,* pp. 3-4), which provides that where any part of the income of a trust "may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor", then such part of the income shall be taxed to the grantor. Except that the nominal grantor of each of the two sets of trusts is the other spouse, the facts of this case come literally within this section (see *infra,* pp. 16-18), and the Tax Court could hardly help concluding, on the facts before it, that the matched components in the taxpayers' two sets of simultaneous and mirror-image trusts were established in consideration for each other, and are therefore reciprocal. Indeed, the application of the reciprocity principle to Section 167 is peculiarly appropriate in the light of the express Congressional purpose in first enacting Section 219(h), Revenue Act of 1924, c. 234, 43 Stat. 253—the forerunner of Section 167—"to stop this evasion", i.e., the use of "Trusts * * * to evade taxes by means of provisions allowing the distribution of the income to the grantor or its use for his benefit." S. Rep. No. 398, 68th Cong., 1st Sess., p. 25 (1939-1 Cum. Bull. (Part 2) 266, 283).

Nevertheless, in the face of a record overwhelmingly indicating that each trust created on the same day was in consideration of the other, and without in terms disputing the Tax Court's finding to that

effect,[6] the court below concludes (R. 437) that "the doctrine of 'reciprocal trusts', as enunciated in *Lehman* v. *Commissioner*, 109 F. 2d 99, [is not] applicable or controlling in favor of the Commissioner here." By characterizing the *Lehman* doctrine, as applied to the plain facts found by the Tax Court, as a "strained fiction" (R. 437), the court indicates its rejection of the core of the principle; and in stating that the concept did not apply here because of (R. 437) "the plain language of the trust agreements" and "the wording of these trust instruments", the court either misconceives the rationale of the doctrine or announces the view that it can have only the narrowest application, *i.e.*, in the very few cases in which the parties expressly state that they are creating reciprocal trusts. Similarly, when it declares (R. 437) that "the *Lehman* case in no wise *requires* a holding that the trusts were reciprocal" (italics supplied), the court appears seriously to limit the Tax Court's authority to apply the doctrine to those scattered cases in which a finding of reciprocity would be absolutely indisputable, and refuses to permit the Tax Court to find reciprocity in any other case. But whether by way of repudiation, misconception, or severe limitation, the court's decision conflicts with the holdings in the other circuits, cited above at p. 13, which properly apply the reciprocity prin-

[6] This finding is implicit in the Tax Court's statement that "in substance" each taxpayer was the trustor of the trust of which he was the beneficiary (R. 112, 114).

ciple to facilitate the application of Code provisions, such as Section 167, which seek to tax income to those who earn it.

2. Moreover, the Court of Appeals' suggestion (R. 437) that these taxpayers are not taxable on the disputed income because, as the beneficiaries of the trusts, they did not have "the power to demand payment of any part of the trust income" is, in view of the unchallenged findings of the Tax Court, an interpretation of Section 167(a)(2) of the Internal Revenue Code, *supra*, pp. 3-4, which is both clearly erroneous and in direct conflict with the consistent interpretation of other circuits.[7]

a. The Tax Court found that the income of each trust (R. 112, 114) "could have been distributed * * * [to the actual grantor] in the manner specified in section 167(a)(2) of the Internal Revenue Code." Read against the provisions of that subsection, the Tax Court's statement is a finding that the income of each trust could, in the discretion of the taxpayer-grantor or of "any person not having a substantial adverse interest" (Section 167(a)(2)), be distributed to the taxpayer. Since it is undisputed that whether income could be distributed in the tax years depended on the exercise of discretion by the advisory com-

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[7] This portion of the opinion seems to hold that Section 167 cannot apply even though the taxpayers are viewed, under the "reciprocal trust" doctrine, as the grantors of the trusts of which they are the beneficiaries.

mittees of each trust (R. 437; see *supra*, pp. 8, 9, 10), this is equivalent to a finding that the committees had no adverse interest. And there can be no doubt, under the decisions in other circuits, that the Tax Court was correct in holding that no member of any of the four advisory committees had a "substantial adverse interest" to the grantor-beneficiary of the particular trust because, under the consistent definition of that phrase, no person has a substantial adverse interest in the income of a trust unless he has a direct interest under the instrument, *i.e.*, a vested or contingent remainder in the corpus or its accumulations. *Ewald* v. *Commissioner*, 141 F. 2d 750 (C.A. 6); *Altmaier* v. *Commissioner*, 116 F. 2d 162 (C.A. 6); *Helvering* v. *Evans*, 126 F. 2d 270 (C.A. 3), certiorari denied, 317 U.S. 638; *Kent* v. *Rothensies*, 120 F. 2d 476 (C.A. 3); *Commissioner* v. *Caspersen*, 119 F. 2d 94 (C.A. 3), certiorari denied, 314 U.S. 643; *Loeb* v. *Commissioner*, 113 F. 2d 664 (C.A. 2), certiorari denied, 311 U.S. 710; *Fulham* v. *Commissioner*, 110 F. 2d 916 (C.A. 1); cf. *Reinecke* v. *Smith*, 289 U.S. 172; *Rollins* v. *Helvering*, 92 F. 2d 390 (C.A. 8), certiorari denied, 302 U.S. 763.

Of the two trusts executed on June 14, 1935, the trust of which Tobin was the beneficiary had an advisory committee (during the tax years) of Tobin and two employees. The committee of the wife's trust created on the same day consisted (during the tax years) of the wife, her sister,

and an employee of Tobin. It is an understatement to say that Tobin and the two employees, considered collectively, did not have a substantial adverse interest in the income; they in fact had an interest that coincided with Tobin's. Similarly, there is no rational basis for saying that the wife, her sister, and Tobin's employee had a substantial interest in the income adverse to that of the wife alone.[8]

In the light of these facts, of the statute, and of the decisions of the other courts, it follows that the holding of the Court of Appeals that in no event would income from the four trusts be taxable to these taxpayers is, on any reading, an interpretation of Section 167(a)(2) that does violence to the unambiguous statute and the decisions under it. Thus, if by the statement that (R. 437), "The trust instruments reveal that no beneficiary ever had the power to demand payment of any part of the trust income," the court below has held that Section 167(a)(2) requires, as a condition of taxability, that the taxpayer have the right to demand income without regard to other persons, the holding is a clear misreading of the statute and is in square conflict with the holdings of all of the cases cited, *supra*, p. 17. If, however, the court has held that the advisory committees here had an adverse interest in the

[8] The advisory committees of the trusts created on November 14, 1935, *supra*, pp. 9, 11, although consisting of different individuals, were no more adverse in their interest to the income than the committees of the June 14 trusts.

income, the holding is both erroneous and in direct opposition to the principles announced in those cases for determining when a "substantial adverse interest" exists. *Supra,* p. 17.

b. In addition, the implication from the emphasis given in the opinion below to the fact that no part of the income of the trusts was distributed in the tax years (R. 437) is that the court thought that that fact was material in defeating the tax. This conception of the statute is directly at variance with the interpretation given the statute by other Courts of Appeals which have uniformly held that the fact that income is not in fact distributed is immaterial because "Section 167 is not concerned with what *is* done under a trust agreement but with what *might be* done thereunder." *Rollins* v. *Helvering, supra,* p. 395; *Helvering* v. *Evans, supra,* pp. 272-273. "The very purpose of the statute is to tax to the settlor income which he does not actually receive." *Loeb* v. *Commissioner, supra,* p. 667.

CONCLUSION

This petition for a writ of certiorari should be granted.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

OCTOBER, 1950.

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